CNX Coal Resources (CNCX)

INVESTMENT REVIEW
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Summary

- Common Units are currently yielding ≈31%, common unit distribution protected by partnership structure.
- Stable customer base, with a strong portfolio of multi-year sales contracts and limited exposure to retiring power plants.
- High BTU, Low Sulfur Thermal Coal mined via highly cost efficient long-wall method.
- Risks: Thermal coal prices, natural gas substitution, limited growth opportunities from drop downs, environmental headwinds.

Introduction: CNX Coal Resources LP (NYSE:CNXC) units are currently trading at a 43% discount to the IPO price having suffered a precipitous drop due to the perception of distribution growth opportunities as limited, especially in a persistently challenging coal market, and because of the market wide sell off. This superficial analysis is unsurprising (especially the given the focus of MLP investors on distribution growth, rather than finding investments that are high yielding at the current time) but fails to recognize the value that can be purchased today at a discount. CNXC is an opportunity to buy significantly discounted coal assets, backed by an industry- leading balance sheet, low-cost production and a stable customer base. The CONSOL Energy MLP spin-off also has a significant yearly distribution, that at current prices is equivalent to a 31.25% yield.

Company Description: CNX Coal Resources LP is a Master Limited Partnership that manages CONSOL Energy's thermal coal properties in Pennsylvania. Assets, partially owned (20%) and fully managed, include three underground thermal coal- mines that principally supply utilities on the US East Coast. CNXC had the unfortunate luck of having its IPO this year (July 1, 2015), an unfortunately ill-timed move, that was prompted by the continued shift in focus of CONSOL Energy from coal to natural gas.

The Bottom Line: CNXC is a relatively simple story. The Pennsylvania coal complex is composed of three mines (Bailey, Enlow Fork and Harvey) together they are several times larger than the island of Manhattan and form the largest producing underground coal mine in North America. Together the mines have reserves of 785 million tons and produce an average of 28.5 million tons a year. The mines are collocated and feed into a centralized processing facility which is serviced by a dual batch train loadout facility that operates twenty-four hours a day and has the highest loading capacity on the east coast.

CNXC owns 20% of the complex (with the remaining 80% still owned by CONSOL) or approximately 6.76 tons of coal reserves per common unit. With a current TEV of $361.68 million, unit holders control coal at a levered cost of $2.30 a ton. Furthermore, since 2006 CONSOL has invested $2 billion in production and logistics infrastructure. Given a market cap of $157 million and the 20% ownership, unit holders are paying $0.39 on the dollar for recently improved mine infrastructure. The recent investment in infrastructure has the additional benefit of lowering maintenance CapEx for the immediate future to approximately $30 million a year, limiting expenses going forward for a traditionally capital-intensive business.

Finally, there is the distribution, at the current time CNXC is paying a minimum quarterly distribution of $0.5125 per unit per quarter (total annual distribution of $2.05 per unit). Not only is the unit yield particularly rich at the current prices but it is safe, with management recently announcing that agreements are in place for the sale of 93%, 61% and 49% of expected production in 2016, 2017 and 2018, with a price range of $49 to $54 per ton for committed and priced tons in 2016. Additionally, it is worth noting that forecasted production is based on a 4-day work week, the assets are currently being managed to create cash flow, and management, if presented with the opportunity, could significantly increase production.

If CNXC sells only the pre-sold minimum (4.8 million tons) and receives no more than $49 a ton for all of the coal sold, the company should still generate approximately $50 million in cash for distribution to unit holders and the general partner, enough for a unit distribution to all 23.3 million units of $2.06 after the 2% general partner interest.

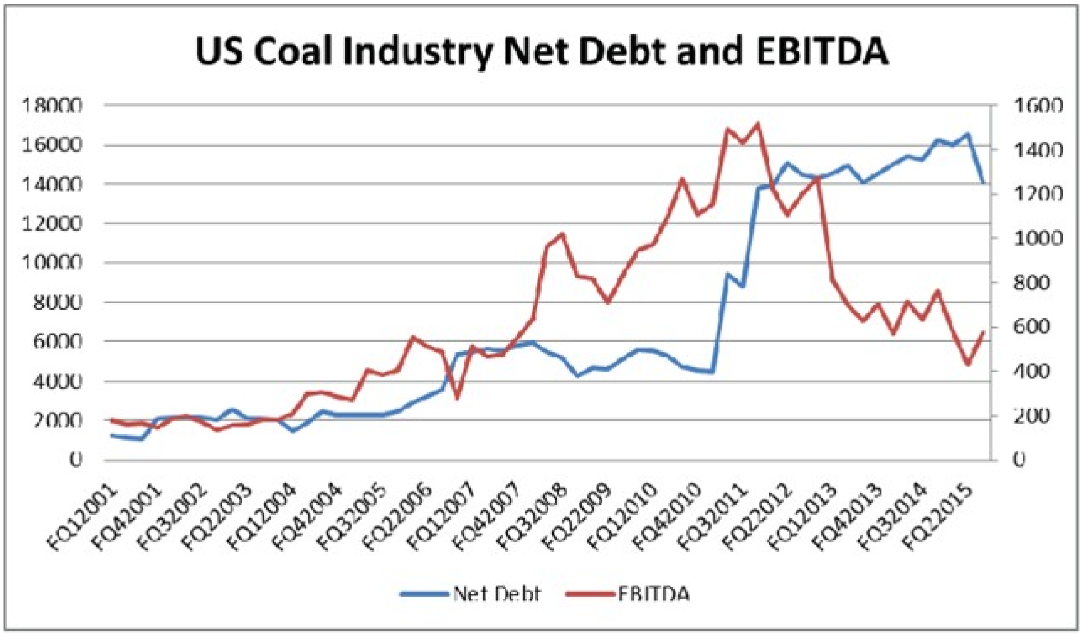
The distribution to common unit holders also benefits from an important structural consideration. At the time of the initial IPO, CNXC issued 1.61 million common units and 11.611 million subordinated units to CONSOL Energy, Greenlight Capital acquired 5.0 million units, and finally, 5.0 million common units were offered to the public. The partnership agreement establishes an order of distribution priority, the 11.61 million common units and the 2% partnership interest must be paid a distribution equal to $2.05 before the subordinated units are paid a distribution. The subordination period is three years unless the distributions to both common and subordinated units in 2017 is equal to 150% the minimum.

The subordination period creates significant margin of safety, reducing the distributable cash that CNXC needs in order to meet the minimum quarterly distribution by roughly 50%. Assuming a cost structure in 2016 similar to 2015, common unit holders will get paid the minimum distribution even if the 2016 pre-sold contracts somehow lapse and CNXC only manages to sell 4.5 million tons at $40 a ton.

What are the Other Risks? In addition to considering the safety of the unit distribution investors in CNXC need to consider coal price risk, the charge that the company has limited growth opportunities and the significant environmental headwinds faced by all coal companies. Forecasting coal markets is beyond that scope of this particular write up but we review growth opportunities and environmental headwinds below.

Growth Opportunities: CNXC has been marketed to investors, as have almost all MLPs, as a stable growth opportunity; as such, most investors are concerned with its growth opportunities. Do they exist? How will they be paid for? Although, we do not think the long-term value of this investment necessarily arises from its growth opportunities (after all a 31% yield is very appealing on its own) there are plenty of growth opportunities for CNXC. In addition to the obvious growth opportunities, the remaining 80% of the Pennsylvania mining facility owned by CONSOL (which would correspond to $350-400mil in additional EBITDA), the Buchanan mine, the Cardinal States Gathering System and the Baltimore Marine Terminal; CNXC has an opportunity to take advantage of the severely overextended and distressed US coal industry in general.

The US coal industry is currently mired in an industry-wide balance sheet mess, the result of leveraging up at the peak of the most recent coal price cycle in order to pursue empire-building transactions, which have since proved ill-founded. Just as the industry EBITDA peaked, the industry loaded up with debt, just in time for the fall in coal prices.



The US currently produces about 39% of its electricity from coal. The reality is that despite any balance sheet problems the industry may have, the US needs most of the coal that the companies depicted in the chart above produce. Because of past decisions, the industry is ripe for restructuring:

- The majority of publicly traded domestic producers have EBITDA/Interest Coverage ratios below 2x.
- Some of the industries publicly traded debt trades for less than a penny on the dollar and much of it sells for $0.50 on the dollar or less.

One of the major tasks for the industry going forward will be restructuring, this will be a significant task and require coal companies with clean balance sheets to come to the rescue. According to a recent Credit Suisse report reducing the sector Net Debt/EBITDA multiple of 15.5 to a multiple of 2 implies $14.3bn refinancing requirement based on LTM EBITDA. As a profitable, cash flow positive coal company, with industry expertise, and a clean balance sheet CNXC could be a major beneficiary of other coal, companies who were sold assets at well above intrinsic value and are now forced to sell those same assets for whatever they can get.

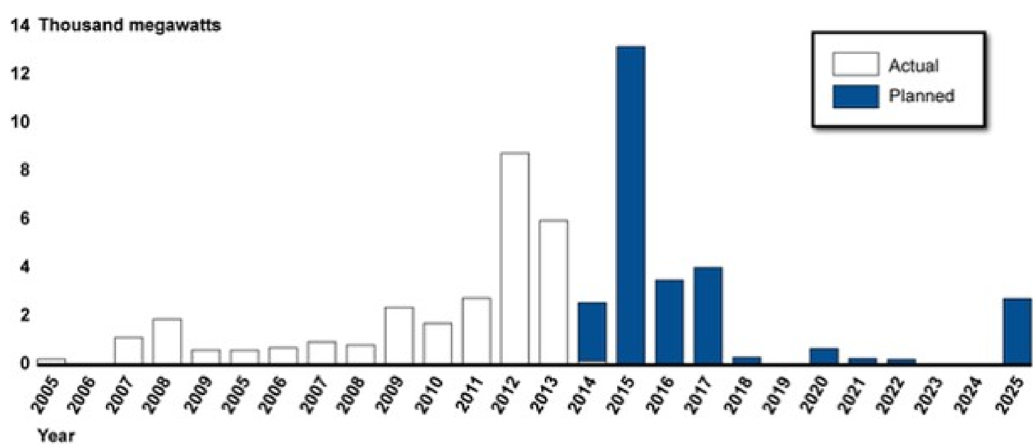
Any growth will have to be financed creatively, as management has already stated. Furthermore, given the current state of the coal industry and the MLP structure the only feasible financing mechanism will likely be an additional issuance of partnership units. It is not clear if borrowing, the typical approach for most MLPs to finance growth, is even feasible at the current time. Bond markets may not be closed to CNXC given its clean balance sheet, but would likely be prohibitively expensive.

If management were to decide that they must grow the distribution at any cost, which would be a mistake, issuance of additional partnership units would be the surest path to additional capital.

Given that management avoided the capital allocation mistakes of other coal companies in the 2011-2013 period, we are optimistic that they will manage the partnership, as is, until the opportunity set for investment growth make sense from an ROIC perspective. This contention is supported by management, who are focused on ensuring coal assets produce cash to help fund CONSOL Energy's natural gas operations. CONSOL still owns 80% of the Pennsylvania mining complex and a total of 11 million common and subordinated units of CNXC. Paying for either drop downs from CNX or the purchase new assets in the open market, unless valued at distressed levels, through either dilution of the partnership or onerous debt would not support this goal. If such an event occurred, it would signal the need for careful reconsideration of any existing investment in the company.

Environmental Headwinds: There is no question the environmental pressure and regulatory issues are a significant threat to the US coal industry. At the current time, several proposed regulatory policies may affect coal-fired utilities, and by extension, coal mining companies. For investors in CNXC, the risk is that these regulations negatively affect operations in the next five years. We believe the five-year risk to be limited.

Although proposed regulation does not create an environment in which additional coal-fired utility capacity is likely to be added to the US grid, there is a limit to the speed at which electrical generation capacity can be a removed from the grid. To remove coal-fired generating capacity utilities must plan for other sources of baseload electricity to replace it. At the current time, the majority of planned retirements have been announced. The most damaging year for the industry was the last year, because of the 2015 compliance requirement of MATS.



Source: GAO analysis of SNL Financial data. | GAO-14-672

Over the next five-year period utility retirements are far more limited (see chart above), and CNXC has no current customers with planned retirements before 2020. That does not mean new retirements will not be announced, but the regulatory environment has become more complex in the wake of the recent Supreme Court ruling on MATS. MATS was intended to establish a federal standard limiting the emission of pollutants such as mercury, but last year the Supreme Court ruled that the EPA did not adequately consider costs when it constructed the regulation. Although this ruling is unlikely to result in changes to planned retirements, it does take some of the pressure off the industry.

Additionally, because of regulatory implementation timelines, the mining and utility industries have some breathing room before they have to comply with new regulations. Finally, it is worth noting that in 2014 CNXC sold 19.4 Mt (74% of total) of coal to utilities with scrubbers in place, under construction, or that had not announced plans to retire generating capacity before 2020. Given that high level of pre-sold coal and multiyear contracts, a significant percentage of CNXC coal appears as safe as US coal can be from regulatory interference.

We would be remiss if we did not include one final comment on the recent Paris Agreement. While 186 nations, accounting for 96% of global carbon emissions, did agree to a comprehensive global effort to limit warming to 2 degrees or less, significant hurdles remain to implementation, which is being left up to individual countries. The Paris Agreement is a significant step forward for attempts at addressing global warming but it is going to take time to see if the agreement results in any real changes, and it would seem unlikely to prompt immediate change.

Short Review of Some Key Environmental Regulations

1) Mercury & Air Toxics Standards (MATS): Established federal standard limiting emission of pollutants such as Mercury. The regulation prompted the closure of older coal-burning power plants but was challenged because the EPA did not consider costs when limiting emissions. The Supreme Court overturned the regulation in 2015.

2) Cross-State Air Pollution Rule (CSAPR) and the Clean Air Interstate Rule (CAIR): Regulation aims to limit emissions that contribute to ozone levels and fine particle pollution across state borders. Phase 1 of CSAPR, which came into effect in January 2015, specifically requires 28 states to reduce annual SO2 emissions, which may be a tailwind for CNXC as it prompts utilities to switch from higher sulfur ILB coal to lower sulfur NAPP, CAPP or PBR coal. PBR coal has the lowest sulfur content of any US coal, but it is principally East-Coast states that are regulated under CSAPR, and PBR coal may not be cost competitive given transport cost and the significantly lower heat content. CNXC claims a $6 to $13 per ton transportation advantage over ILB coal, given the additional distance PBR coal would have to travel, combined with the lower heat content, the NAPP coal CNXC mines likely has a significant cost advantage.

3) Clean Power Plan: CPP aims to regulate carbon dioxide emissions from the power sector, with the goal of reducing nationwide CO2 emissions by 30%.

4) National Ambient Air Quality Standards (NAAQS)

Are we paying a price that is too high?

"The greatest risk doesn't come from low quality or high volatility. It comes from paying prices that are too high. This isn't a theoretical risk; it's a very real." The Most Important Thing by Howard Marks

According to our analysis CNXC is trading at a significant discount to the present value of its future levered free cash flow. Please keep in mind that we modeled CNXC as if it was a traditional corporation, paying taxes, as any investor will have to take into account taxes on the distribution, an inaccurate shortcut for sure but a not unreasonable approach. Additionally, the shortcut makes comparison to other publicly traded coal companies easier.

We also believe the CNXC is trading at a significant discount to the present value of its future distribution stream. For our model, we assumed that the 4th quarter of 2015 would be similar to the 3rd quarter and that the volume of coal mined and price per ton over the next two five year periods would be as follows:

Basic Model Assumptions

	2016	2017	2018	2019	2020	2020+
Coal Sold (Millions of Tons)	4.5	4.5	4.5	5.0	5.0	
Price Per Ton	$49	$45	$40	$45	$49	
Forecasted Revenue (in Mil)	$220.5	$202.5	$180.0	$225.0	$245.0	2% Growth

We believe these assumptions are conservative, but the conservative approach is in keeping with our focus on defensive investing and use of models to create "likely" but stressed or severely stressed value estimates.

Other assumptions include:

- WACC of 8%
- Terminal Growth Rate of 2%
- Terminal EBITDA Multiple of 8x (conservatively chosen based Market Multiples AnalysisTable below)

Market Multiples Analysis of Coal Companies

(Amounts listed in USD. Numbers in millions, except per share data)

			Enterprise Value as a Multiple of:						
		Enterprise	Sales			EBITDA			EBIT
Company	Stock Price	Value(2)	LTM	CY+1	CY+2	LTM	CY+1	CY+2	LTM
Foresight Energy LP	2.65	2,007.3	1.92x	2.04x	2.09x	5.6x	5.5x	6.6x	11.4x
Hallador Energy Company	4.59	381.0	1.01x	1.10x	1.36x	3.8x	4.1x	5.0x	6.8x
Natural Resource Partners LP	1.14	1,499.4	3.34x	3.06x	3.20x	5.5x	5.3x	5.6x	NM
Alliance Resource Partners LP	13.61	1,687.1	0.73x	0.73x	0.77x	2.1x	2.3x	2.4x	3.4x
Arch Coal Inc.	0.83	4,463.9	1.66x	1.67x	1.73x	12.0x	13.8x	16.7x	NM
Peabody Energy Corporation	6.69	6,096.6	1.03x	1.08x	1.15x	11.2x	12.0x	10.6x	NM
Cloud Peak Energy Inc.	1.80	477.1	0.40x	0.41x	0.41x	3.7x	4.0x	4.7x	15.7x
Alpha Natural Resources, Inc.	0.01	2,596.5	0.70x	0.85x	1.12x	31.4x	NM	NM	NM
		High	3.34x	3.06x	3.20x	31.4x	13.8x	16.7x	15.7x
		Average	1.35	1.37	1.48	9.4	6.7	7.4	9.3
		Median	1.02	1.09	1.25	5.6	5.3	5.6	9.1
		Low	0.40	0.41	0.41	2.1	2.3	2.4	3.4
CNX Coal Resources LP	**7.95**	**371.3**	**1.30x**	**1.38x**	**1.03x**	**3.6x**	**3.9x**	**3.2x**	**5.5x**

(1) Financial data as of 1/8/2016

(2) Calculated as Market Value of Equity plus total debt, non-controlling interest and preferred stock, less cash & equivalents.

Discounted Cash Flow Analysis for CNXC

In Millions

	Pro-Forma Results		Projected FY											
			Inc Q4 Est	Fully Modeled					2% Growth				
	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
Sales	275.0	326.8	271.5	230.3	202.5	180.0	225.0	245.0	249.9	254.9	260.0	265.2	270.5
Cost of goods sold	159.5	180.4	149.9	127.1	111.8	99.4	124.2	135.2	138.0	140.7	143.5	146.4	149.3
Gross Profit	115.5	146.4	121.6	103.2	90.7	80.6	100.8	109.8	111.9	114.2	116.5	118.8	121.2
SG&A	24.8	22.6	18.8	15.9	14.0	12.4	15.5	16.9	17.3	17.6	18.0	18.3	18.7
EBITDA	90.7	123.8	102.8	87.3	76.7	68.2	85.2	92.8	94.7	96.6	98.5	100.5	102.5
EBITDA Margin	33.0%	37.9%	37.9%	37.9%	37.9%	37.9%	37.9%	37.9%	37.9%	37.9%	37.9%	37.9%	37.9%
Less: D&A	(25.6)	(34.2)	(28.4)	(24.1)	(21.2)	(18.8)	(23.5)	(25.6)	(26.1)	(26.7)	(27.2)	(27.7)	(28.3)
EBIT	65.1	89.6	74.4	63.2	55.5	49.4	61.7	67.2	68.5	69.9	71.3	72.7	74.2
Less Taxes	(22.8)	(31.4)	(26.1)	(22.1)	(19.4)	(17.3)	(21.6)	(23.5)	(24.0)	(24.5)	(25.0)	(25.5)	(26.0)
Tax-effected EBIT	42.3	58.2	48.4	41.1	36.1	32.1	40.1	43.7	44.5	45.4	46.3	47.3	48.2
Plus: Depreciation and amortization	25.6	34.2	28.4	24.1	21.2	18.8	23.5	25.6	26.1	26.7	27.2	27.7	28.3
Less: Capital expenditures	(82.2)	(68.1)	(35.0)	(27.5)	(30.0)	(30.0)	(30.0)	(30.0)	(30.0)	(30.0)	(30.0)	(30.0)	(30.0)
Less: Interest	(2.1)	(6.9)	(9.2)	(9.5)	(9.5)	(9.5)	(9.5)	(9.5)	(9.5)	(9.5)	(9.5)	(9.5)	(9.5)
(Increase)/decrease in working capital	NA	(1.5)	(17.4)	(2.9)	(1.9)	(1.6)	3.1	1.4	0.3	0.3	0.4	0.4	0.4
Levered Free Cash Flow	**(16.3)**	**16.0**	**15.2**	**25.3**	**15.9**	**9.9**	**27.3**	**31.2**	**31.6**	**33.0**	**34.4**	**35.9**	**37.4**

Levered Free Cash Flow	25.3	15.9	9.9	27.3	31.2	31.6	33.0	34.4	35.9	37.4
Discount period	1.0	2.0	3.0	4.0	5.0	6.0	7.0	8.0	9.0	10.0
WACC	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%
Discount factor	0.926	0.857	0.794	0.735	0.681	0.630	0.583	0.540	0.500	0.463
PV of Unlevered Free Cash Flow	**23.4**	**13.6**	**7.9**	**20.1**	**21.3**	**19.9**	**19.3**	**18.6**	**18.0**	**17.3**

Perpetuity Growth Method	
Weighted average cost of capital:	8.0%
Net present value of free cash flow	179.4
Terminal growth rate	2.0%
Terminal value	610.8
Present value of the terminal value	415.7
Enterprise value	595.0
Less: Net debt*	(189.0)
Equity value	406.0
Diluted shares:	23.300
Equity Value Per Share	**17.43**

Share Price as of: 1/15/2016 — 6.80

EBITDA Multiple Method	
Weighted average cost of capital	8.0%
Net present value of free cash flow	179.4
Terminal multiple	8.0x
Terminal value	803.8
Present value of the terminal value	547.0
Enterprise value	726.4
Less: Net debt*	(189.0)
Equity value	537.4
Diluted shares:	23.300
Equity Value Per Share	**23.06**

Stock Price Sensitivity Analysis for CNXC

Share price in USD

		Weighted average cost of capital								
	17.43	6.00%	6.50%	7.00%	7.50%	**8.00%**	9.00%	10.00%	11.00%	12.00%
Terminal Growth Rate	0.00%	19.65	17.53	15.70	14.11	12.70	10.34	8.42	6.84	5.50
	0.50%	21.50	19.07	17.00	15.21	13.65	11.05	8.98	7.27	5.85
	1.00%	23.72	20.88	18.50	16.48	14.73	11.86	9.59	7.76	6.24
	1.50%	26.43	23.06	20.29	17.96	15.97	12.77	10.28	8.29	6.67
	2.00%	29.82	25.73	22.43	19.71	17.43	13.81	11.05	8.89	7.13
	2.50%	34.19	29.06	25.04	21.81	19.14	15.01	11.93	9.55	7.65
	3.00%	40.00	33.34	28.31	24.37	21.20	16.41	12.94	10.30	8.22
	3.50%	48.14	39.04	32.51	27.58	23.72	18.06	14.09	11.14	8.86
	4.00%	60.36	47.03	38.11	31.70	26.87	20.05	15.44	12.11	9.58

		Weighted average cost of capital								
	23.06	6.00%	6.50%	7.00%	7.50%	**8.00%**	9.00%	10.00%	11.00%	12.00%
Terminal Multiple	6.00x	18.92	18.47	18.03	17.61	17.19	16.40	15.65	14.94	14.27
	6.50x	20.53	20.04	19.57	19.11	18.66	17.80	16.99	16.22	15.49
	7.00x	22.14	21.62	21.11	20.61	20.13	19.20	18.33	17.50	16.71
	7.50x	23.75	23.19	22.64	22.11	21.60	20.60	19.67	18.78	17.94
	8.00x	25.36	24.76	24.18	23.61	23.06	22.01	21.01	20.06	19.16
	8.50x	26.97	26.34	25.72	25.12	24.53	23.41	22.34	21.34	20.38
	9.00x	28.59	27.91	27.26	26.62	26.00	24.81	23.68	22.62	21.61
	9.50x	30.20	29.48	28.79	28.12	27.47	26.21	25.02	23.90	22.83
	10.00x	31.81	31.06	30.33	29.62	28.93	27.61	26.36	25.18	24.05

Conclusion: As already stated the return on this investment is found in the safe and significant distribution yield. At current prices, investors are going to earn 31% on their money before any appreciation in the price of the stock. Put another way, investors have a 31% margin of safety if they are looking for a long-term opportunity to invest in coal. No other company in the coal sector offers the same quality assets, clean balance sheet and substantial margin of safety that CNXC does at current prices.

One final note on how to interpret the current market price of CNXC seems warranted given the market's pessimism about the company and coal. It is worth inverting the valuation problem with a CNXC and asking what the market has priced into the current partnership units. If we assume that the market price reflects investors outlook for the next decade, what does that the price imply about the coal market going forward? If we run a reverse DCF, starting with the current share price, and assuming the existing cost structure, the price of CNXC implies that coal will trade at or less than $40 a ton for most of the next decade. It also assumes that in 2016 CNXC will sell no more than 83% of the currently pre-sold, pre-priced volumes and receive 90% of the low-end price of the pre-sold volumes. Although anything is possible and no one denies that coal is facing significant headwinds, the current price implies a particularly dire ten-year outlook.

Although catalysts for appreciation of the stock price are limited, the dividend is uniquely safe in the world of coal. Furthermore, because the yield is 31% investors would be wise to invest regardless of whether the stock price appreciates or not. At the current price the yield alone doubles your investment in less than four years.

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